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# **Hong Kong Market Outlook - Implications of the CNH market**

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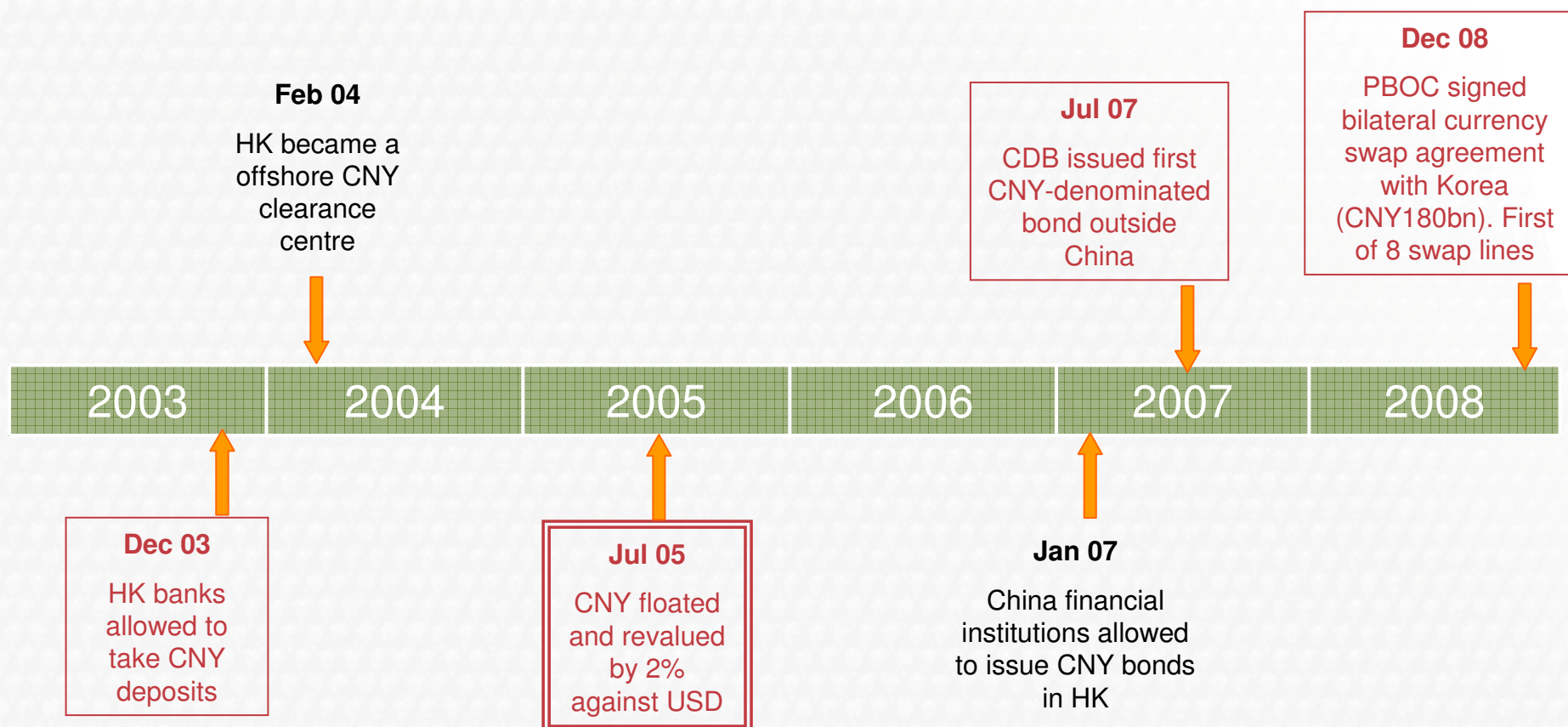
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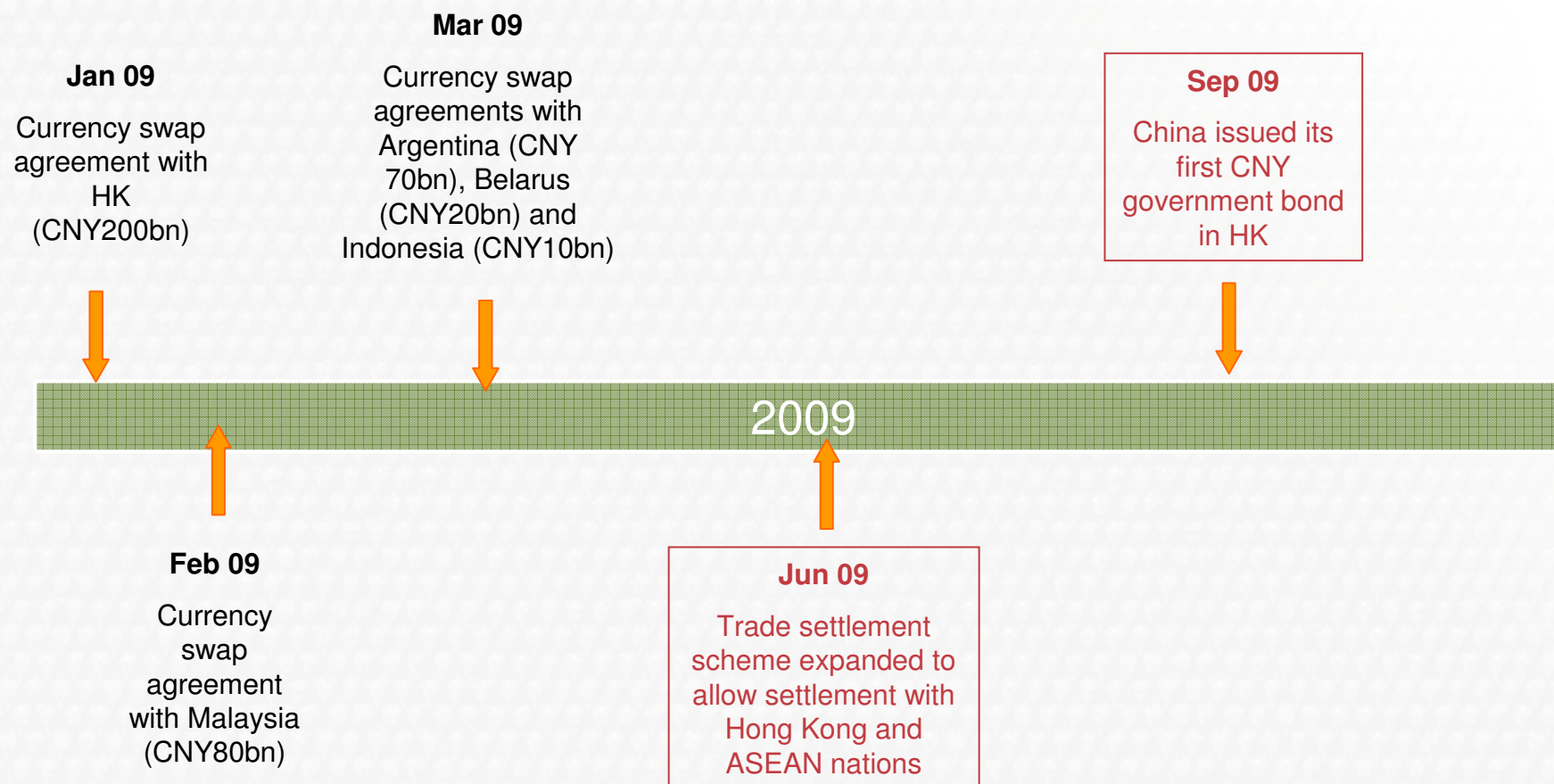
# The CNH roadmap

## China's market liberalisation (2002-2008) – the early days



# The CNH roadmap

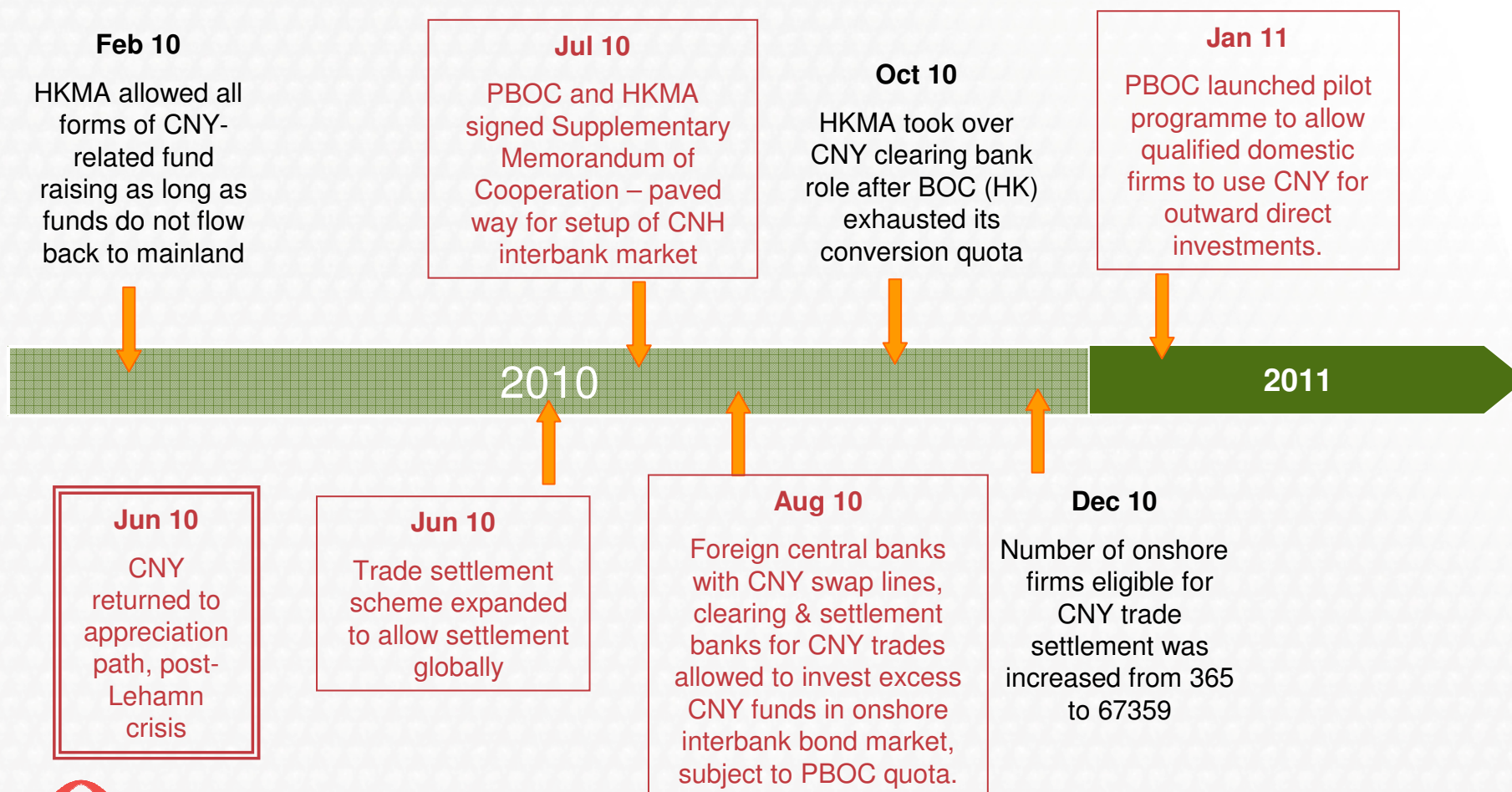
China's market liberalisation (2009) – setting goal for CNY internationalisation





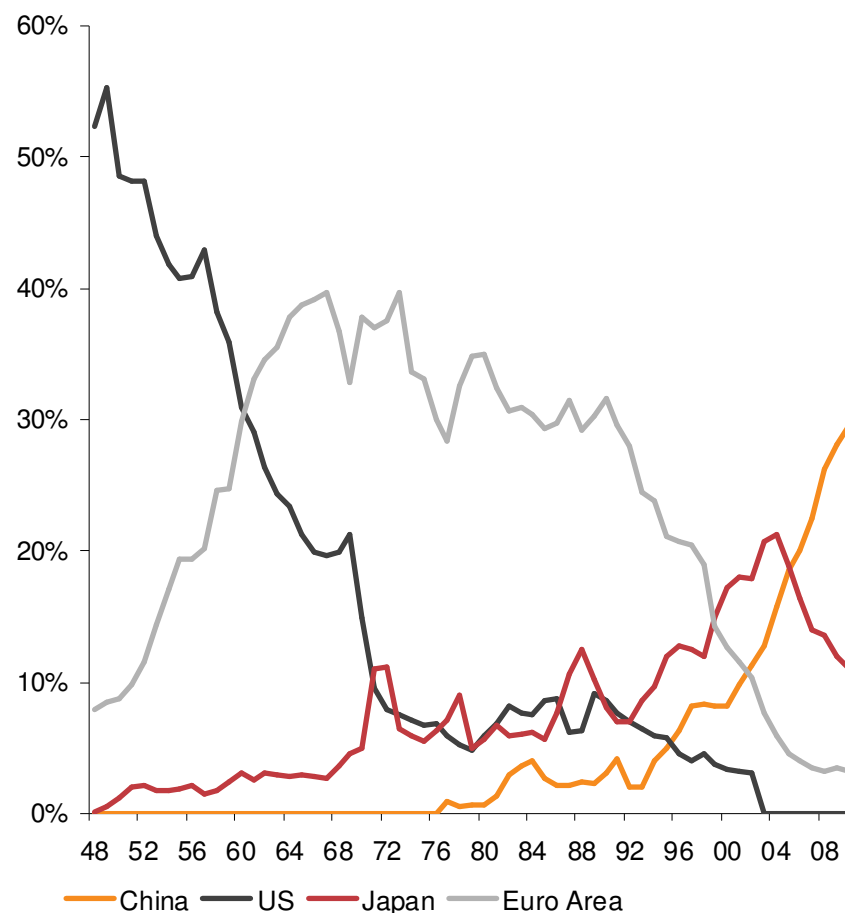
# The CNH roadmap

## China's market liberalisation (2010-2011) – the Big Bang

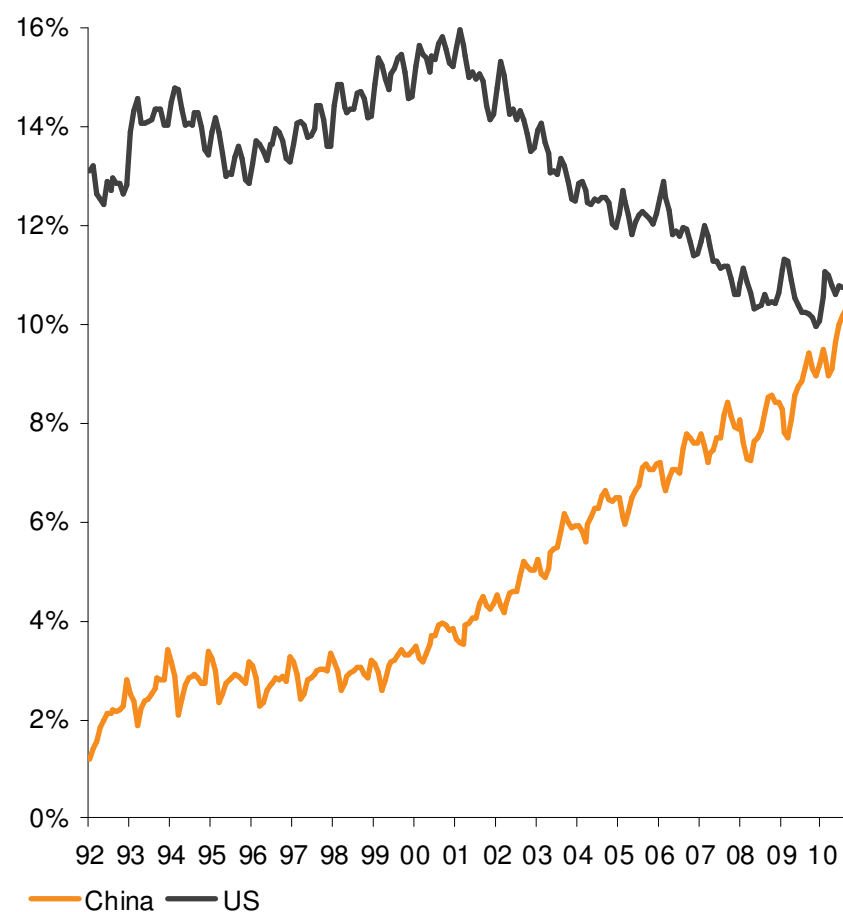


# Potential of CNY as a world reserve currency

Share of world reserves – China vs. G3



Share of world trade – China vs. US



Source: Bloomberg, RBS

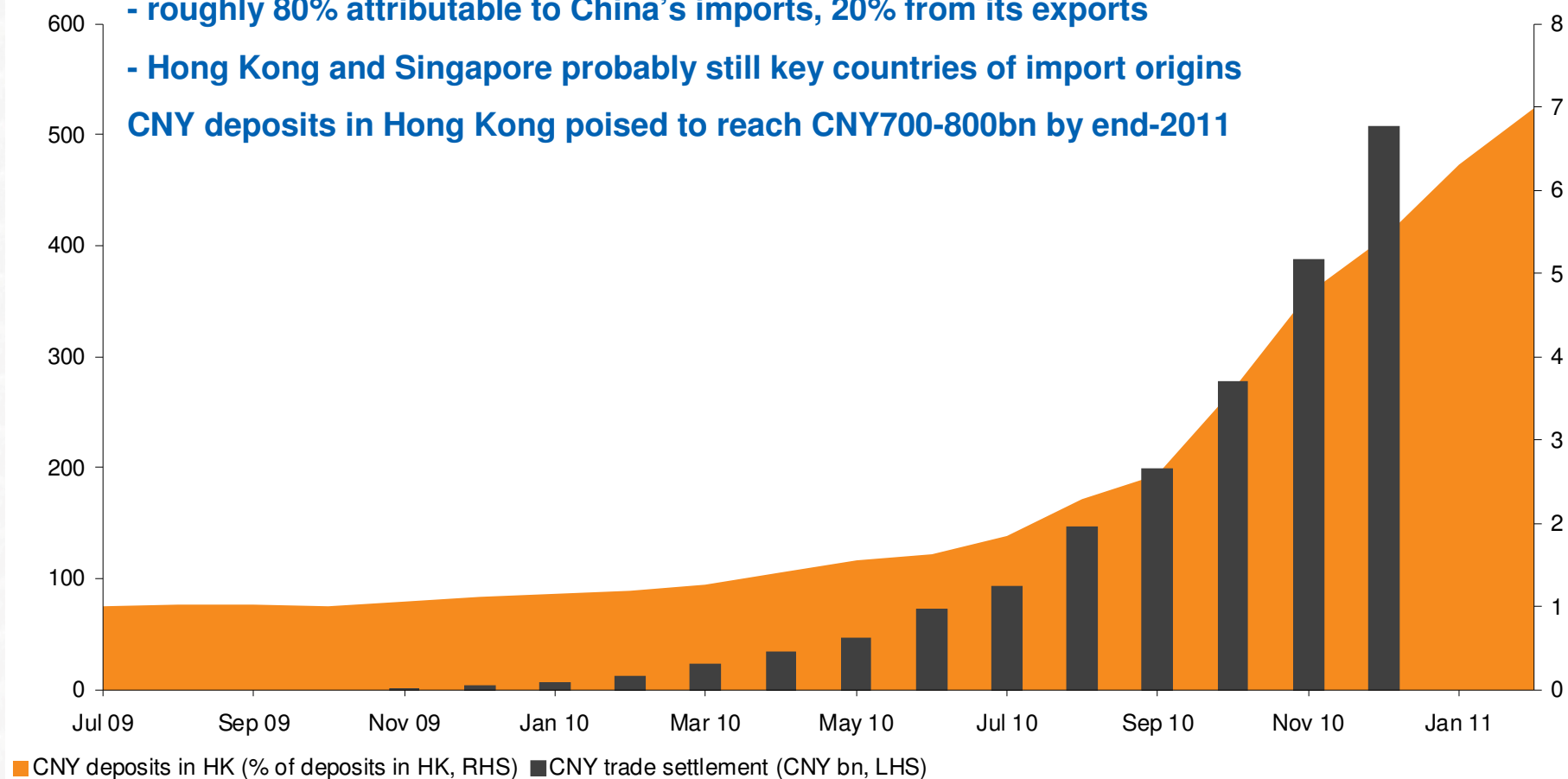
# CNY trade settlement scheme huge boost to CNH deposit base

Since initiation in Nov 09, banks have cumulatively settled CNY510bn worth of trade

- roughly 80% attributable to China's imports, 20% from its exports

- Hong Kong and Singapore probably still key countries of import origins

CNY deposits in Hong Kong poised to reach CNY700-800bn by end-2011





# New offshore CNY centres – potential competition for HK

## Conditions for setting up an offshore CNY centre

1. Strong trade ties with China
2. CNY swap line from PBOC
3. Central clearing directly with PBOC
4. Domestic currency traded in China's onshore interbank market
  - a. China interbank currently quotes USD/CNY, EUR/CNY, JPY/CNY, HKD/CNY, CNY/MYR, USD/SGD
  - b. PBOC said more foreign currencies will be allowed to trade as CNY crosses

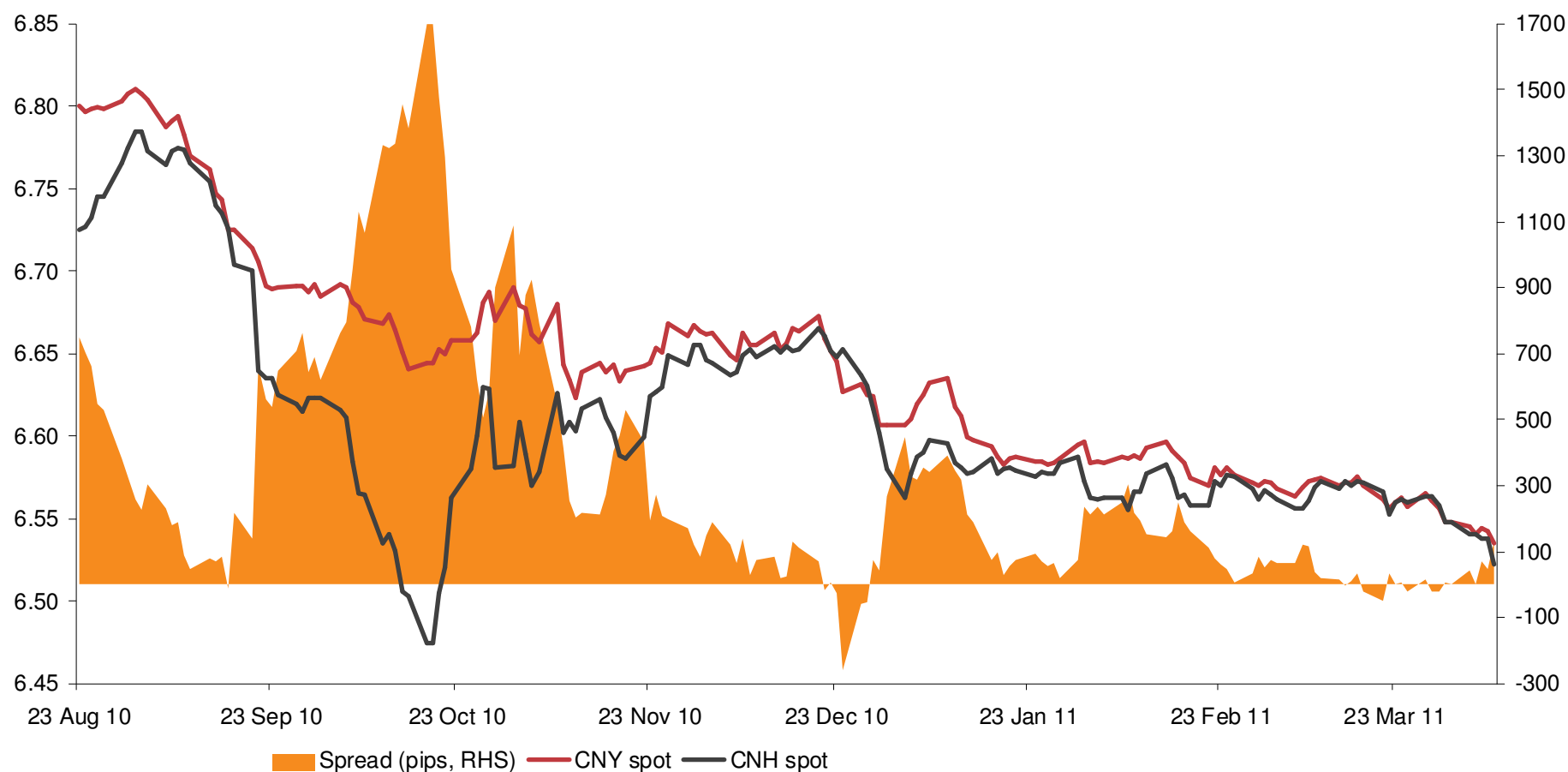
## PBOC's CNY swap lines

	Date of swap line agreement	Size of swap line (CNY bn)	% of China's total trade
Korea	Dec-08	180	7.0
Hong Kong	Jan-09	200	7.8
Malaysia	Feb-09	80	2.5
Indonesia	Mar-09	100	1.4
Argentina	Mar-09	70	0.5
Belarus	Mar-09	20	0.07
Iceland	Jun-10	3.5	0.01
Singapore	Jul-10	150	1.9

Source: IMF, CEIC, RBS

# Market anomaly 1: FX – CNH spot premium over onshore CNY spot...

From peak of 2.5%, CNH spot premium over onshore CNY spot has narrowed to 0.05%

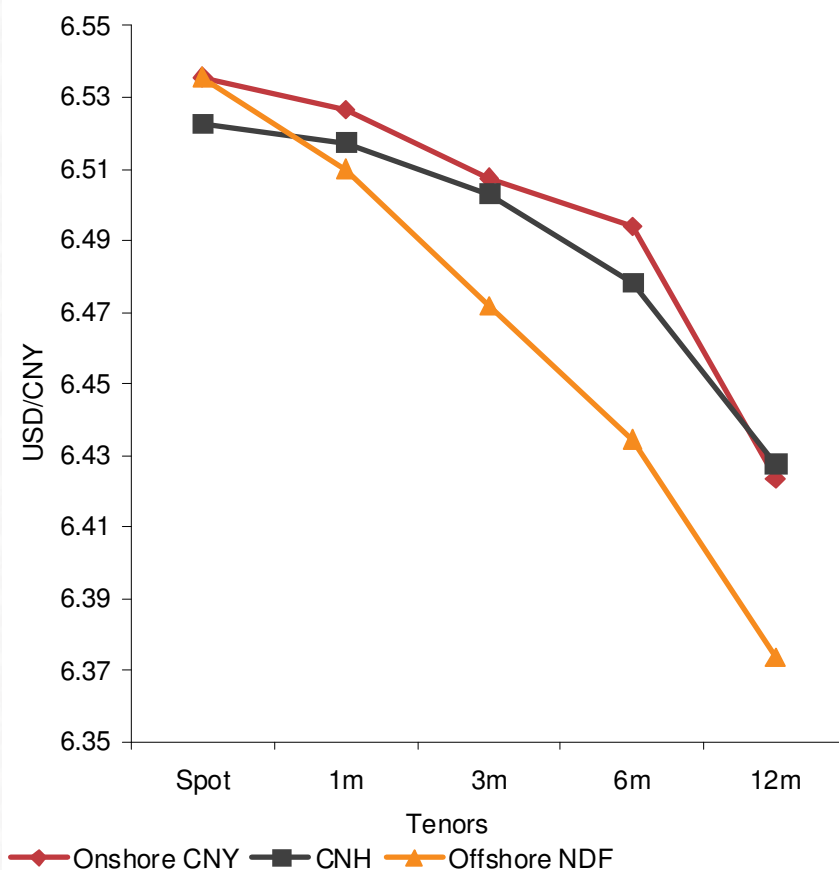


Source: Bloomberg, RBS

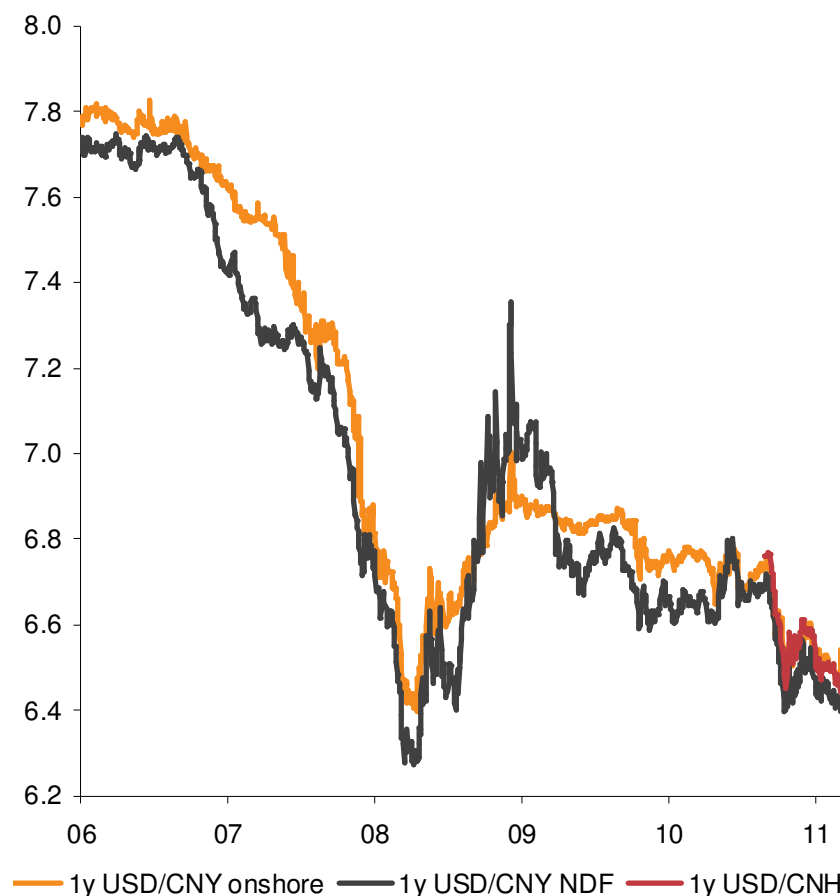


# ... leading to divergence in FX forward curves

FX forward markets – onshore, CNH and NDF



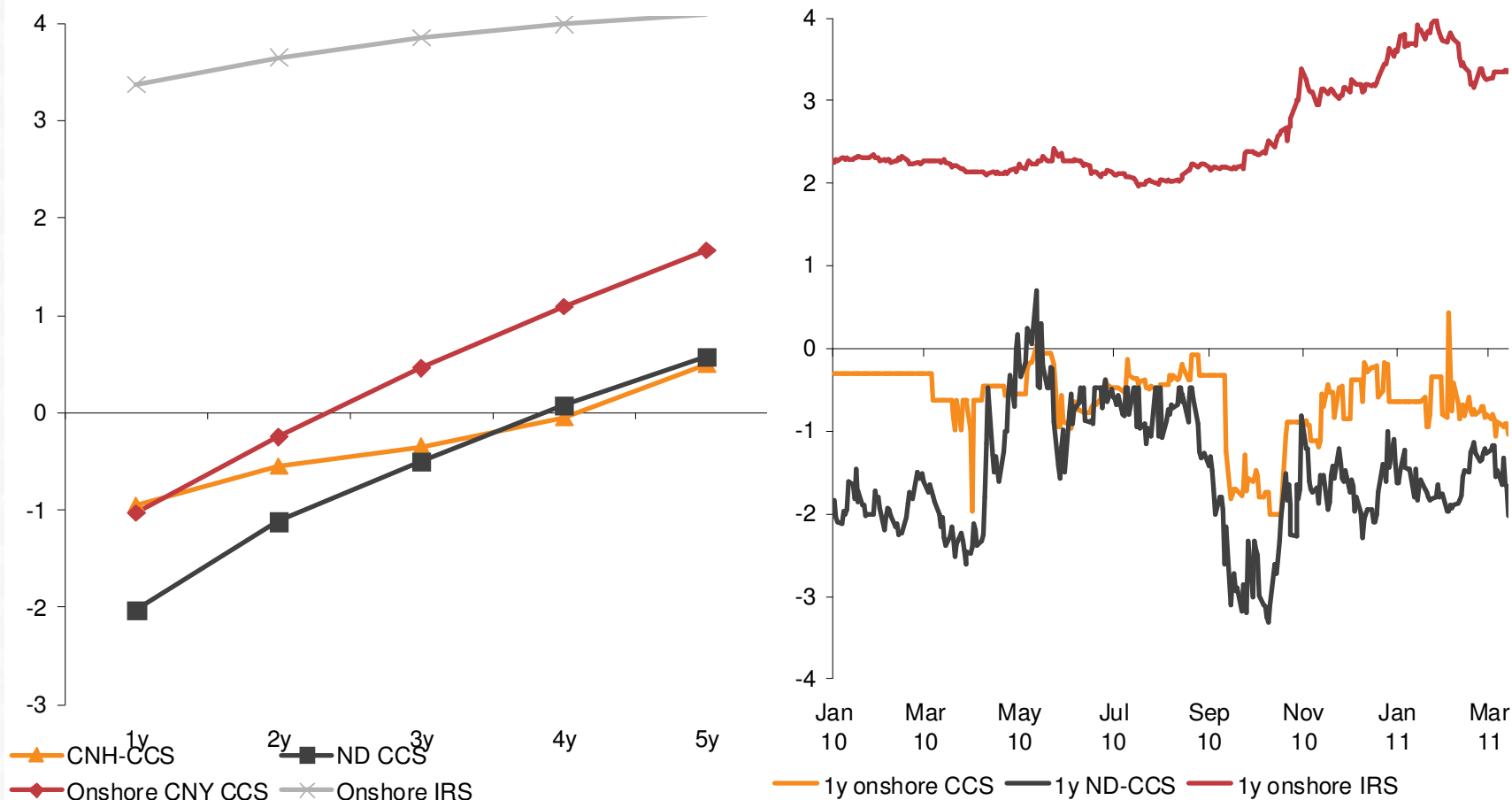
USD/CNY 1y forward – onshore vs. NDF



Source: Bloomberg, RBS

# Markets anomaly 2: interest rates – CNH yield curve differ in both levels and directions from onshore swap curve...

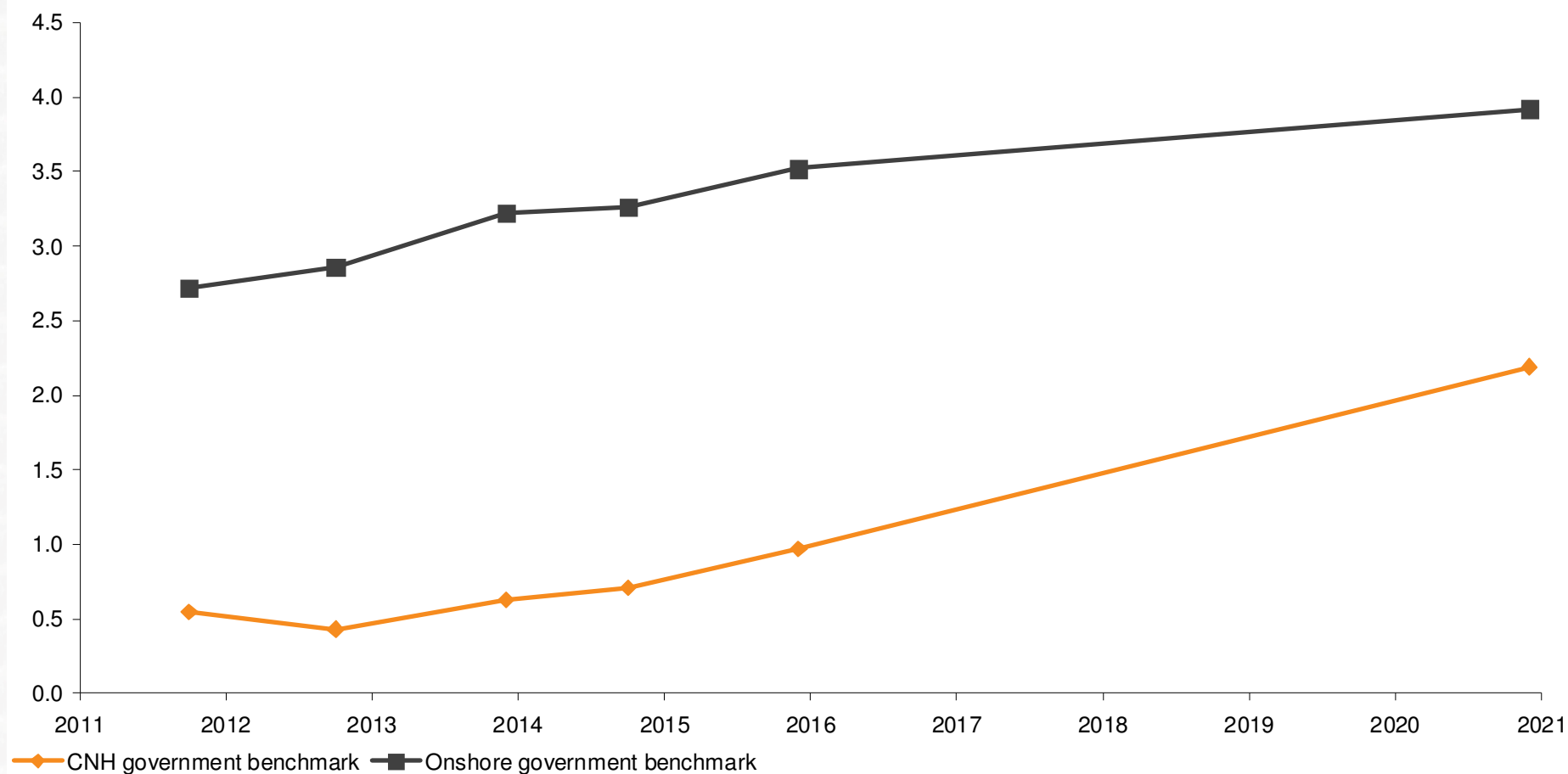
CNH interest rate term structure vs. offshore ND-CCS, onshore IRS and CCS



Source: Bloomberg, RBS

... which led to huge premium of CNH bond issues over onshore issues, including Chinese government issues

Sovereign benchmark curve set by China MOF CNH issues vs. onshore benchmark curve



Source: Bloomberg, RBS



# The next phase – adding asset classes, expanding geographical coverage

## •Mini QFII Scheme

China's domestic securities houses and fund managers to directly tap into overseas investors to invest in onshore China bonds and equities

## •CNY-denominated equity listing in HK

Listing CNY-denominated equities offshore; investors can exchange for CNY via liquidity facility, with profits/ losses to be converted back into HKD

## •Inward foreign direct investment settlement

Allowing foreign firms to bring offshore CNY funds into China for direct investments

## •More offshore CNY centres

The 4 pre-requisites

- a. strong trade flows with China
- b. access to PBOC's CNY swap line
- c. CNY central clearing directly with PBOC
- d. trading of offshore centre's domestic currency in China interbank market

# Implications of CNH on HKD

## On HKD's dollar peg

- A re-peg is not de-peg
- CNH increased chances of HKD re-pegging to CNY...
- ... conditional on CNY becoming fully convertible (~ 5 years' time)
- Asset substitution – USD deposit base in HK being eroded, not HKD deposit base
- Meanwhile, Hong Kong' strong fundamentals allow dollar peg

## On HKD interest rates

- USD rates remain anchor for HKD rates until HKD re-pegs
- Re-peg pressure will come from CNH rates, not onshore CNY rates
- Fortunately, CNH rates are also anchored by USD rates...
- ... as long as China maintain border control between CNH and onshore CNY
- Bigger uncertainty is in USD rates – when will Fed starts hiking? when will it unwind QE?

# History of HKD dollar peg

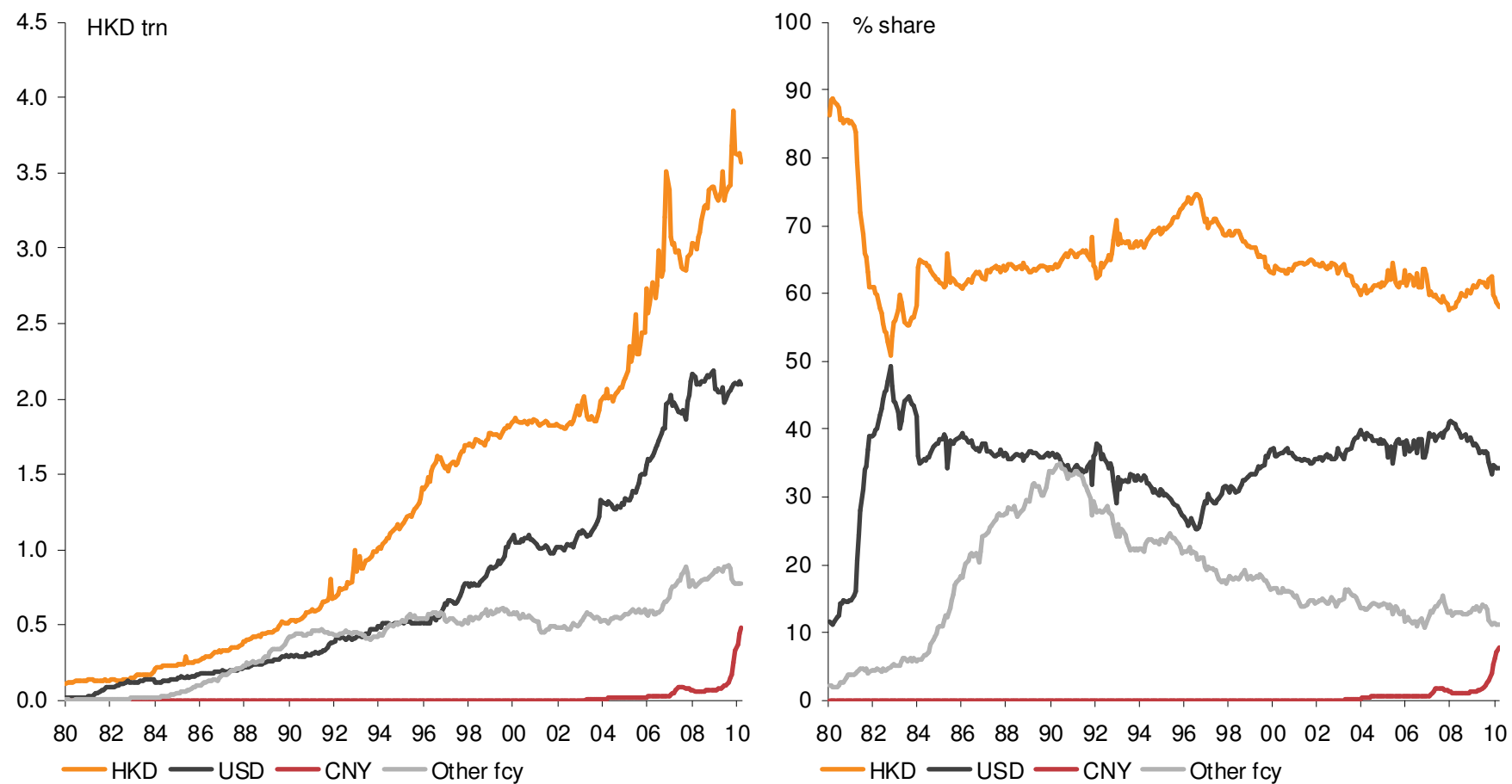
USD/HKD forwards have not priced in resumption of CNY appreciation plus growth of CNH





# “Asset substitution” underway

CNH deposits are eroding USD deposits, not HKD deposits

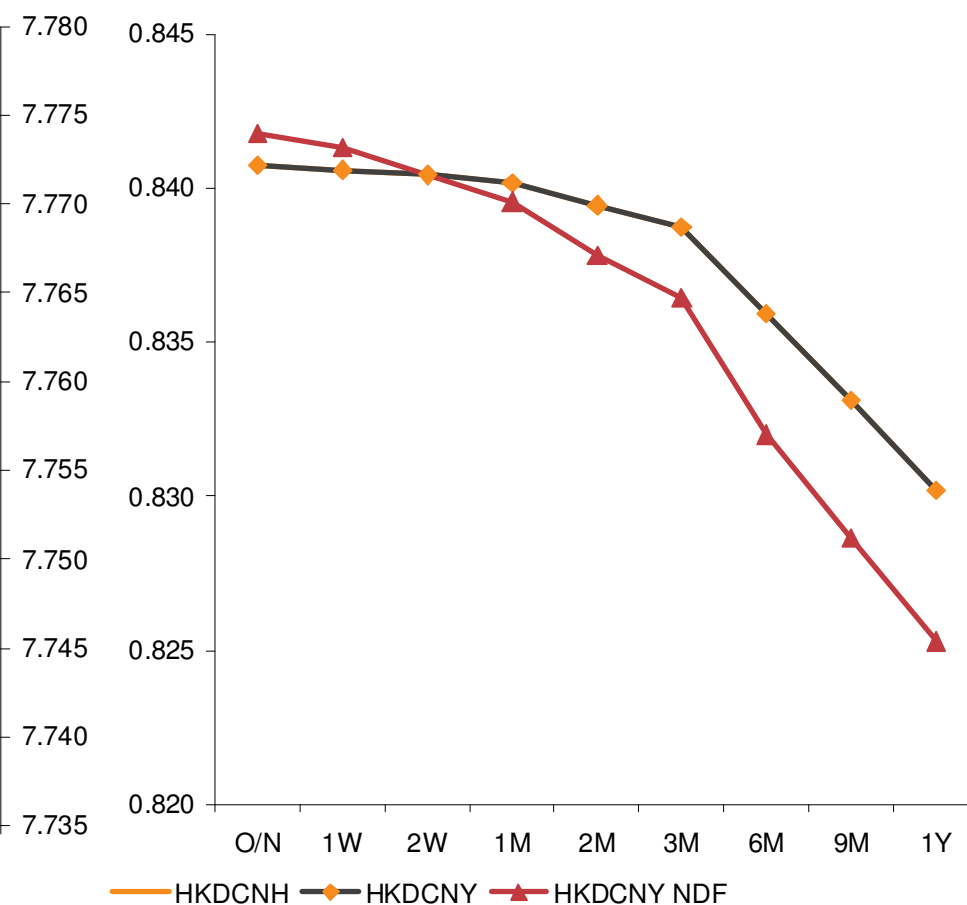
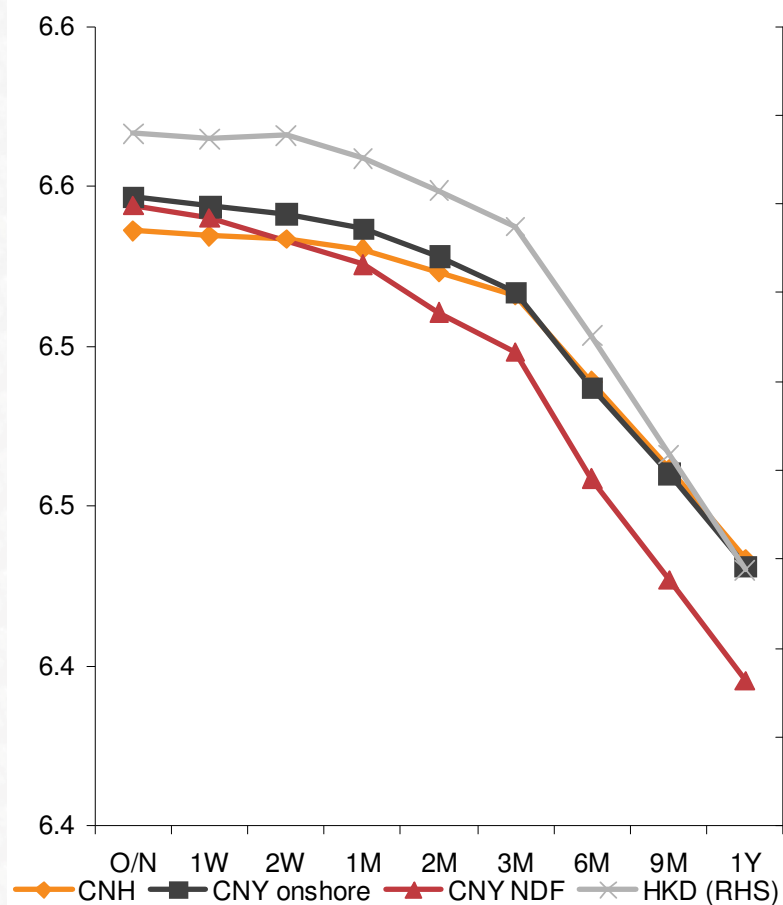


Source: Bloomberg, RBS

# HKD FX forward vs. CNH forward – implying sustained HKD depreciation vs. CNY

USD/HKD vs. CNH, onshore CNY, offshore CNY NDF

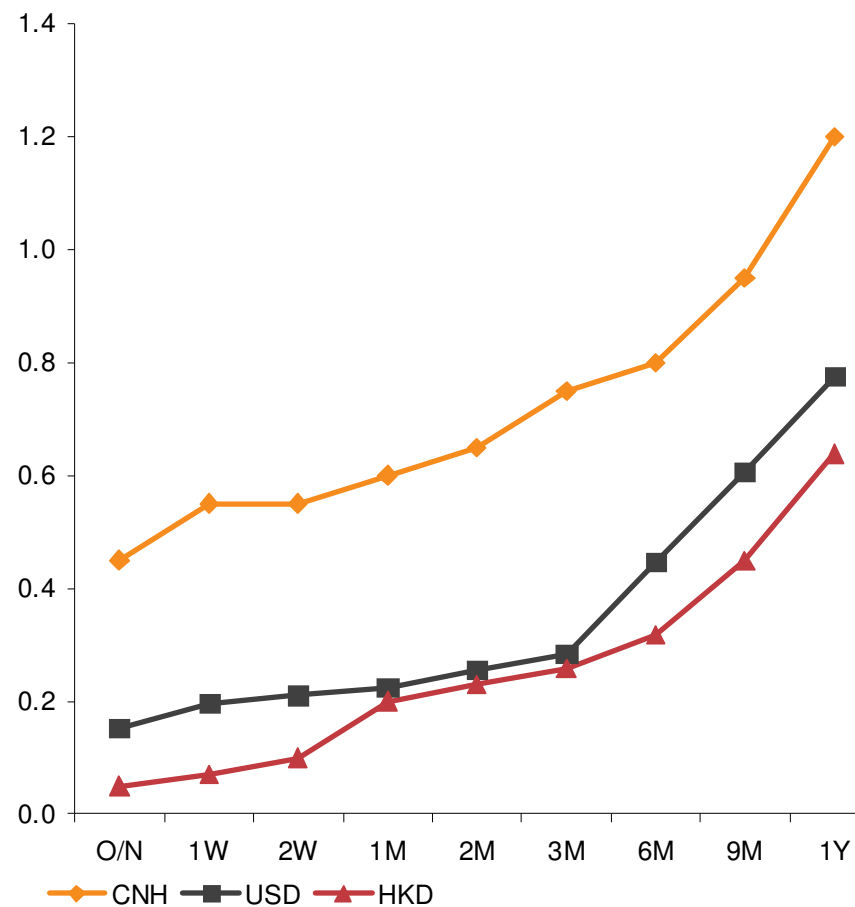
HKD/CNH vs. HKD/CNY, HKD/CNY NDF



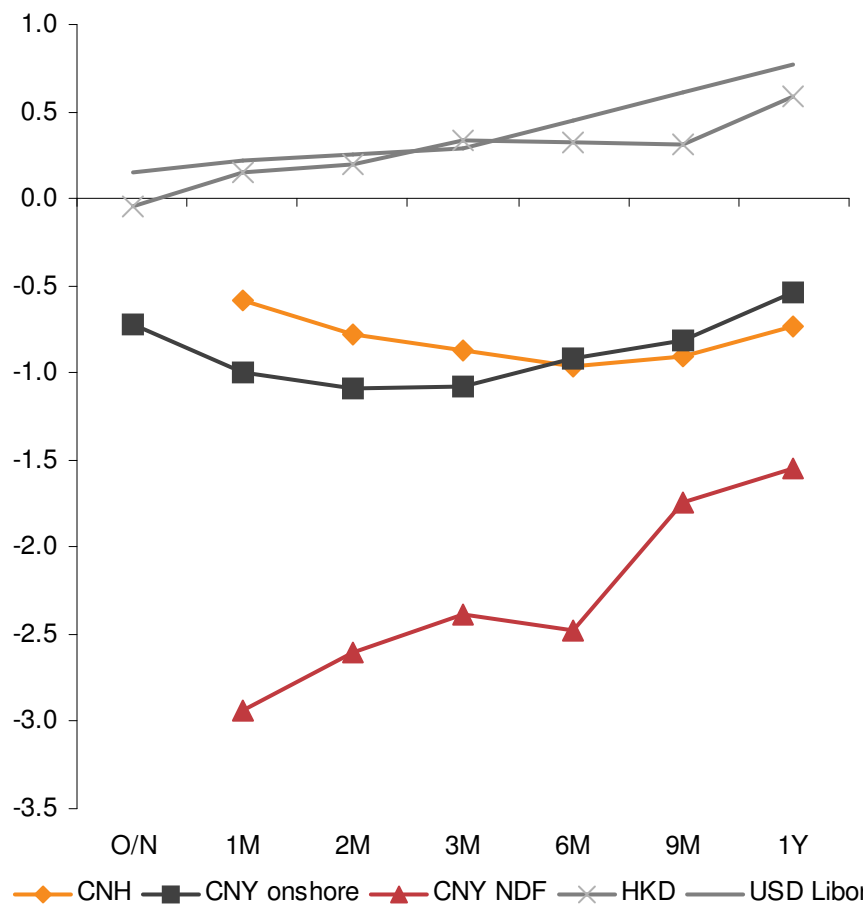
Source: Bloomberg, RBS

# HKD interest rates vs. CNH rates – anomaly between interbank deposit rates and implied swap offer rates

Interbank rates – hibor vs. CN-hibor, Libor



Rates implied from FX forward curves

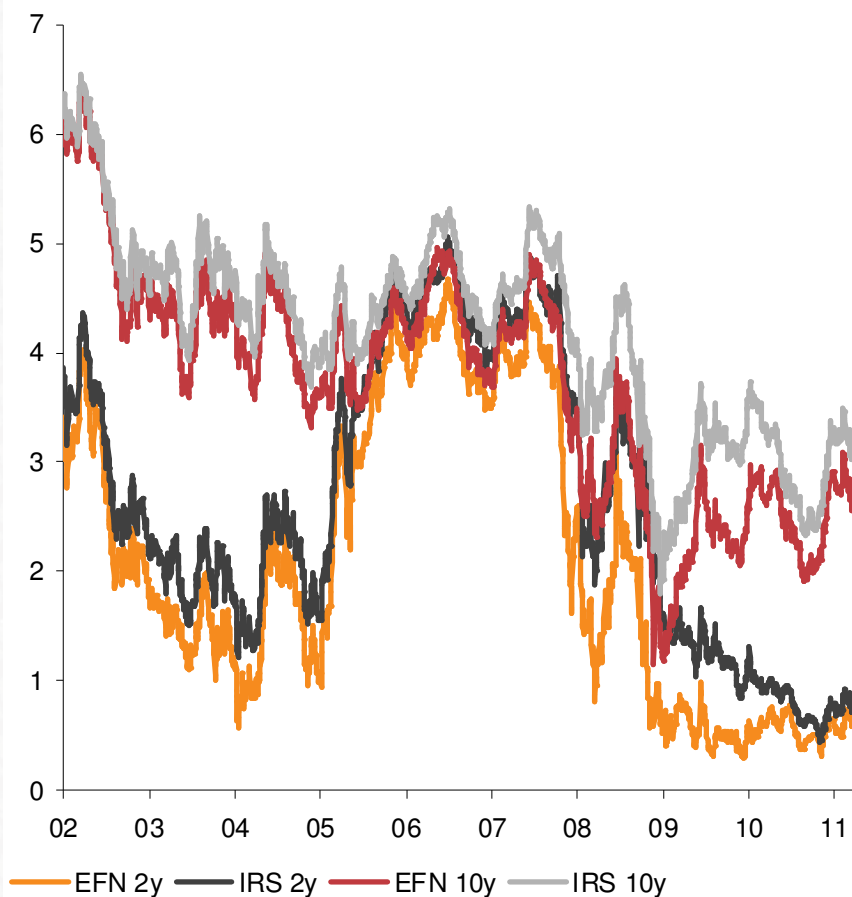


Source: Bloomberg, RBS

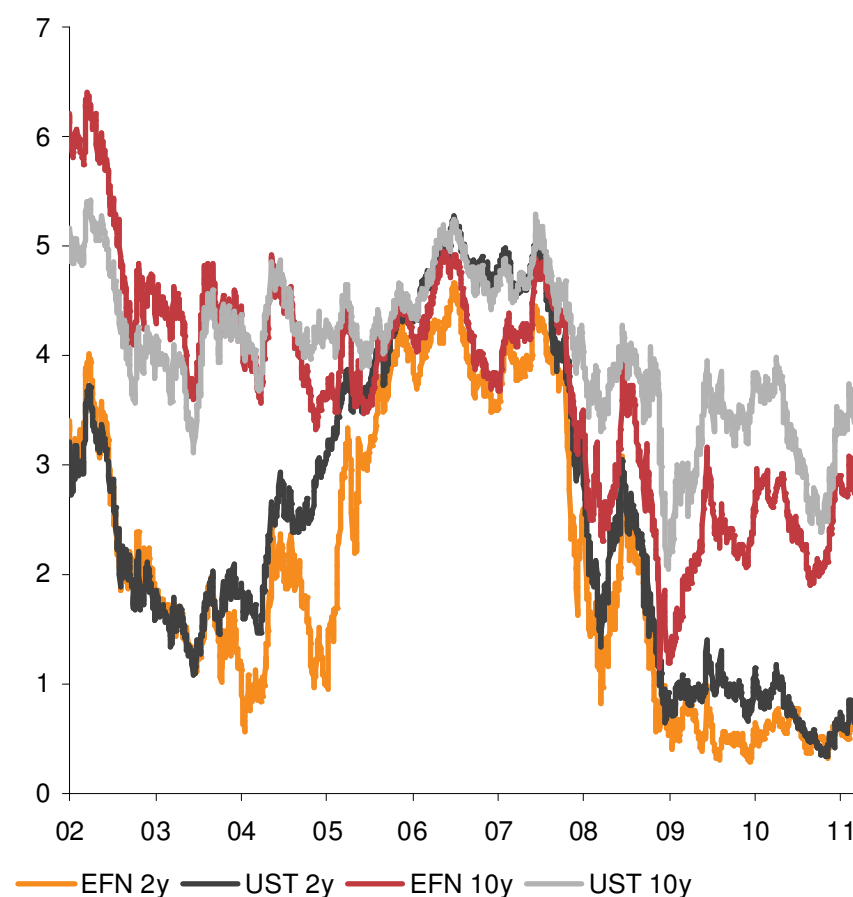


# HKD rates – front-end lower, curve to steepen vs USD

EFN vs. IRS



EFN vs. UST



Source: Bloomberg, RBS

# The CNH Market

- Types of CNH products
- CNY, CNH and CNY NDF compared
- CNH market liquidity
- Examples of CNH FX investment products

# Overview

- **CNH market** – developing and does not offer the liquidity many need to hedge their risks
- **Onshore CNY** – generally not open to Hong Kong investors and involves CNY/CNH basis risk
- **CNY NDF/NDS** – better liquidity than CNH but also involves basis risk
- **Some structured investment products are available for participants to reduce or increase exposure to CNH/HKD and/or provide better yields than CNH money markets**



# Snapshot of CNH-denominated product availability

CNH product	Availability	Remarks
Spot	Yes	USD 500mn interbank volumes
Forward	Yes	There are now CNY DF, CNY NDF and CNH DF curves
CCS	Yes	Illiquid
Money market	Yes	Interbank trading relatively thin amid CNH 'pooling' in small number of institutions
CDs/structured notes	Yes for CDs	CDs launched; structured notes and deposits in early development stage
FX options	Yes	Illiquid
Structured products	Not all	Fully funded structures so far
Bonds	Yes	Hong Kong CNH bond market continues to build

# CNH vs. onshore CNY and offshore CNY NDF

	CNY	CNH	CNY NDF
Location	China onshore	Abroad, (Hong Kong for clearing)	Abroad
Who is allowed to buy/sell	Only companies in China (with supporting documents)	Everyone outside China	Everyone outside China
Freely convertible	No	Yes	n.a.
Products available	Spot, Forwards and Options	Spot, Forwards and Options	Forwards and Options
Remittance outside China	No	n.a.	n.a.
Remittance into China	n.a.	Yes, for trade purposes	n.a.
How is it settled	Delivery	Delivery	Cash settled in USD
Allowed purposes	Current and capital account with supporting documentation	Trade purposes into China alone, otherwise restrictions	n.a.
Fixing	No fixing	No fixing	2 business days ahead of maturity
Documentation needed	Trade documents, or PBOC/SAFE approvals for capital account transactions	Trade documents for transfers into/out of China	None
Liquidity	Deep Spot and forward to 1y	Deep Spot and forward to 3 months, modest liquidity at 1 year	NDF: Out to 1y NDS: Liquid out to 5 years, some liquidity out to 10 years

# Market liquidity

	Tenor	Daily Average Volume	Volume per Transaction	Bid to Offer
<b>Onshore CNY Deliverable</b>				
USDCNY FX Spot	-	USD 10 bn	USD 10-15mm	10-20 pips
USDCNY FX Forwards & Swaps	Liquid out to 1y -18 months	USD 6 bn	USD 10-15mm	50-100 pips
<b>Offshore CNY Non Deliverable (settled in USD)</b>				
USDCNY Non Deliverable Forward (NDF)	Up to 1y	USD 3-4 bn	USD 10-20mm	30-50 pips
USDCNY Non Deliverable Cross Currency Swap (NDS or NDCCS)	Liquid out to 5y	USD 20-50mm	USD 10-20mm	20-30 bppa
<b>Offshore CNH Deliverable</b>				
USDCNH FX Spot	-	USD 400-500mm	USD 5mm	10-20 pips
USDCNH FX Forwards & Swaps	Up to 1y	USD 250mm	USD 10mm	50-100 pips
Fixed Income Sovereign Bonds	Up to 10y	Illiquid	CNH 5mm	50-100bp



# USD dual currency investment linked to CNH

## Indicative Terms & Conditions

- **USD Principal** : USD 10 million (equivalent to CNH Principal = CNH 65.2 million)
- **USD/CNH Spot Reference** : 6.5200
- **Tenor** : 3 Months
- **Strike** : 6.5200
- **Redemption Conditions**
  - if USD/CNH Spot at expiry is above Strike, Investor receives CNH Principal with 2.0% p.a. interest
  - If USD/CNH Spot at expiry is at or below Strike, Investor receives USD Principal with 2.0% p.a. interest

## Rationale and Benefits

- This investment is suitable for investors who are sitting on idle USD cash and do not mind converting USD into CNH.
- Allows the investor to take advantage of the implied (from the FX market) and real (from the depo) CNH yield difference as well as access to the CNH option market
- This investment offers higher returns compared to the vanilla money market rates or the sell/buy USD/CNH FX swap plus CNH deposit structure (USD 1.00% p.a.)

## Risks

- If there is depreciation on the Renminbi, the investor could be receiving less than his original invested principal in USD terms.



# CNY Credit Linked Note

## Indicative Terms & Conditions

- **CNY Principal** : CNY 200 million, settled in Settlement Currency
- **Reference Obligation** : China Sovereign
- **Tenor** : 5 years
- **Coupon** : CNY 2.50% p.a. settled in Settlement Currency
- **Redemption** : 100% at maturity, or in event of default the recovery value after close-out of hedges, settled in Settlement Currency
- **Settlement Currency References** : USD or HKD (as mutually agreed on Trade Date) using onshore Spot

## Rationale and Benefits

- This investment is suitable for investors who are in need of CNY linked assets and who are comfortable with China Sovereign credit risk
- Different reference obligations can be used for a tailored risk/reward profile
- This investment offers higher returns compared to the vanilla CNH money market rates and is available to HK investors

## Risks

- Basis risk between CNH and CNY for investors hedging CNH liabilities
- China Sovereign in addition to the usual issuer credit risk

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